5.05 Foreign Investees

When a company has an investment in a foreign division or subsidiary that will be included in the company's consolidated F/S, it must convert the foreign entity's financial information from its local currency, the currency in which it maintains its books and records, into the parent's reporting currency, presumably the U.S. dollar.

The process by which the entity will convert the F/S from the local currency into U.S. dollars will depend on the functional currency.

- If the functional currency is the local currency, the process is referred to as **translation**.
- If the functional currency is the U.S. dollar, the process is referred to as **remeasurement**.

It is also possible that there will be three currencies involved.

- The subsidiary or division may be maintaining its books and records in its local currency.
- Because of the nature of its operations, its functional currency is a different one, but not the U.S. dollar.
- The company is included in the parent's F/S prepared in the reporting currency, the U.S. dollar.

As a result:

- The entity will **remeasure** its financial information from the local currency to the functional currency.
- The entity will then **translate** its financial information from the functional currency to the reporting currency.

Transactional Currency = Local currency (Usually the currency in which books and records are kept)

Remeasurement (I/S)

Functional Currency = Greatest economic impact on company (Currency in which entity generates and expends cash)

Translation (B/S)
(Comprehensive Income)

Reporting Currency = Currency in which the entity prepares its F/S

Translation of Financial Statements

When the local currency is the functional currency, in order to prepare consolidated F/S that are expressed in dollars, the parent will translate the F/S of the subsidiary into U.S. dollars. The basic principles of translation are:

- **Assets and liabilities** are translated at the *current exchange rate*, which is the exchange rate at the balance sheet date.
- **Income statement** items are translated at the *exchange rates effective on the date that those items are recognized* on the F/S.

    - Sales that occurred uniformly throughout the year, for example, would be translated at the **weighted average** exchange rate.
    - A gain on the sale of a piece of equipment will be translated using the rate in effect on the **date the gain** was realized.
    - Intra entity income and expense items that are eliminated in consolidation are translated at the exchange rate in effect on the **date of the intra entity exchange.**
- The amount required to balance the entry is referred to as a **translation adjustment.**
    - The translation adjustment occurs because items are being translated at different exchange rates and the result is not likely to balance.
    - The translation adjustment is not recognized in income but is included in **other comprehensive income (OCI)**.

The normal process for performing a **translation** involves the following steps:

1. Translate all income statement items (weighted average). This will provide a translated amount for net income.
2. Translate items on the balance sheet as follows:
    a. Assets and liabilities are translated using the rates at the **balance sheet date** (end).
    b. Contributed capital accounts (C/S & APIC) are translated using **historical rates**.
    c. Retained earnings is "rolled forward." Net income derived from translating the income statement is added to the ending balance from the prior period. Dividends are translated using the rate in effect on the date of the dividend. The result is the current period's ending balance of retained earnings.
3. The difference will be the translation adjustment recognized in OCI on the balance sheet.

Generally, the cumulative translation adjustment remains in accumulated other comprehensive income (AOCI) until such time as the investment in the foreign investee is either disposed of or substantially liquidated.

The entity may, however, lose a controlling interest in a foreign investee without disposing of it or substantially liquidating it. This might be true, for example, when an entity obtains a controlling financial interest in a foreign VIE and subsequently loses that controlling financial interest due to a change in the relationship or other circumstances.

When this is the case, it will be considered equivalent to a disposal and the cumulative translation adjustment is reclassified out of AOCI and will be recognized in income.

Remeasurement of Financial Statements

When the functional currency is the reporting currency, presumably the U.S. dollar, in order to prepare consolidated F/S that are expressed in dollars, the parent will remeasure the F/S of the subsidiary into U.S. dollars. Remeasurement is intended to present financial information as if all transactions had originally been recorded in the functional currency.

The basic principles of remeasurement are:

- Certain **balance sheet** items (**nonmonetary** assets/liabilities) are remeasured at **historical rates,** the rates that were in effect when the assets were acquired; the liabilities were incurred, or when contributed capital was actually contributed. This includes:
    - Marketable securities and inventory carried at cost.

- Prepaid expenses
- Property, plant, and equipment and its accumulated depreciation
- Intangibles
- Deferred charges, credits, and deferred income
- Preferred stock carried at issuance price and common stock
- Revenues and expenses that are nonmonetary in nature such as cost of sales, depreciation, and amortization

- Monetary assets and liabilities are remeasured using the exchange rate at the balance sheet date.
- Remeasurement of revenues, expense, gains, or losses (I/S) will be determined by their natures.
  - Many revenues and expenses that are incurred throughout the period will be remeasured at the **weighted average** exchange rate.
  - Gains and losses will be remeasured using the **rates in effect on the dates** of the transactions generating the gains and losses.
  - Revenues and expenses that are nonmonetary in nature, such as cost of sales, depreciation, and amortization are remeasured using **historical rates.**
    - Depreciation and amortization are remeasured using the same rates that are applied to the items being depreciated and amortized.
    - Cost of sales is remeasured by remeasuring beginning and ending inventory at their historical rates and purchases at the weighted average rate.
- The amount required to balance the entry is referred to as a **remeasurement adjustment.**
  - The remeasurement adjustment occurs because items are being remeasured at different exchange rates and the result is not likely to balance.
  - The remeasurement adjustment is recognized in **income (I/S).**

The normal process for performing a **remeasurement** involves the following steps:

1. Remeasure items on the balance sheet as follows:
   a. *Monetary assets and liabilities* are remeasured using the rates at the **balance sheet date.**
   b. *Nonmonetary assets and liabilities* and *contributed capital* are remeasured using **historical rates** based on when assets were acquired, liabilities were incurred, and capital was contributed.
   c. The difference is ending retained earnings. The beginning balance will be rolled forward from the previous period and dividends, remeasured using the rate in effect on the dividend date, are deducted. The difference between that amount and the ending balance is the current period's **net income or loss**.
2. Remeasure all income statement items.
3. The difference between net income or loss and the result of remeasuring all income statement items will be the **remeasurement adjustment recognized in income.**

When the functional currency is in a **highly inflationary economy,** which is defined as one that has cumulative inflation of 100% or more over a 3-year period, the reporting currency will be considered the functional currency and F/S will be remeasured rather than translated.